On February 12, 2015, the Securities and Exchange Commission (“SEC”) brought and settled charges against an investment adviser to several alternative mutual funds alleging, among other charges, failure to comply with the custody requirements of the Investment Company Act of 1940, as amended (the “1940 Act”).¹ The violations were uncovered during an SEC examination of the adviser and funds that it manages. To settle the SEC’s charges, the adviser agreed to pay a fine in the amount of $50,000.

The adviser focuses on several alternative investment strategies that involve trading in certain derivatives, including swaps. The SEC’s order alleged that the adviser did not ensure that certain assets of the funds were maintained in the custody of the funds’ custodian; rather, the SEC alleged, the adviser posted approximately $247 million in cash directly to broker-dealer counterparties as collateral for the funds’ derivatives transactions instead of maintaining this collateral in the custody of the funds’ custodian, as required by Section 17(f)(5) of the 1940 Act.

In addition to the custody-related charges, the SEC charged that the adviser caused violations of Section 12 of the 1940 Act, and Rule 12b-1(h) thereunder, by allegedly failing to implement the funds’ directed brokerage policies and procedures following their adoption. Under the funds’ policies and procedures, the adviser had the responsibility for implementing the policies and procedures designed to ensure that any broker selected to execute securities transactions was chosen in accordance with Rule 12b-1. The SEC cited the adviser for allegedly failing to create and maintain certain records required by the funds’ policies and procedures, including (i) an approved list of executing brokers for the funds and (ii) documentation regarding the funds’ compliance with Rule 12b-1(h) policies and procedures.

The enforcement action serves as an important reminder for the growing number of advisers of alternative mutual funds to be mindful of specific restrictions and obligations when managing registered funds that do not apply to private funds and separate accounts. For example, Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940, as amended, requires, among other things, that a “qualified custodian” maintain client funds and securities.² Under the Custody Rule, an adviser may post collateral to a counterparty in connection with a swap on behalf of clients that are not registered funds, provided that the entity holding the collateral is a “qualified custodian” as defined in the Custody Rule. However, Section 17(f)(5) of the 1940 Act generally provides that an investment company that maintains all of its assets in the custody of a qualified custodial bank must maintain its

² While more permissive than Section 17(f)(5) of the 1940 Act, the Custody Rule also imposes certain conditions and limitations on collateral management, particularly when posting collateral to related persons and to counterparties that are not “qualified custodians,” which may include, for example, non-US swap dealers. See Advisers Act Rule 206(4)-2; Staff Responses to Questions About the Custody Rule, Question II.10 (updated as of September 1, 2013).
SEC Fines Alternative Mutual Fund Adviser for Improper Handling of Fund Assets

cash in the custody of the same bank (including cash pledged as collateral in connection with over-the-counter swaps). The custodial bank responsible for maintaining custody of a registered fund's assets also must meet certain requirements under the 1940 Act, including approval by the fund's board of trustees. As noted in the SEC's order, one way to meet the requirements of Section 17(f)(5) is to arrange to have a fund's collateral held by the funds' custodian subject to a tri-party control agreement. These types of agreements have become common practice in the registered fund industry, but they may be novel to an adviser with experience primarily in private funds.

The action is also noteworthy in light of the SEC's Office of Compliance Inspections and Examinations' (“OCIE”) stated priorities for 2015. In outlining its examination priorities for this year, OCIE has noted that “[f]unds holding ‘alternative’ investments, or those offering returns uncorrelated with the stock market, have experienced rapid and significant growth compared to other categories of mutual funds” and that OCIE “will continue to assess funds offering alternative investments and using alternative investment strategies, with a particular focus on: (i) leverage, liquidity, and valuation policies and practices; (ii) factors relevant to the adequacy of the funds’ internal controls, including staffing, funding, and empowerment of boards, compliance personnel, and back-offices; and (iii) the manner in which such funds are marketed to investors.”

The 1940 Act, the rules thereunder, and SEC staff guidance relating to alternative investment strategies are complicated and not intuitive. These standards can constrain a registered fund's ability to employ options, futures, swaps, prime brokerage, repurchase and reverse repurchase agreements, enhanced leverage through securities lending, and other facilities. As the SEC continues to examine alternative mutual funds, advisers to these funds should remain cognizant of the obligations arising under the 1940 Act and the implementation of fund policies and procedures. This action shows that the SEC will bring charges even when the alleged violations do not result in harm to investors.

Authors:

Michael W. McGrath
michael.mcgrath@klgates.com
+1.617.951.9123

Pablo J. Man
pablo.man@klgates.com
+1.617.951.9209

SEC Fines Alternative Mutual Fund Adviser for Improper Handling of Fund Assets